Indiana Department of Revenue
Efficiency Task Team Report
of the
General Government Subcommittee
of the
Government Efficiency Commission

November 8, 2004

Department of Revenue Task Team Report
November 1, 2004

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Our subcommittee was given the task of measuring current efficiencies and making suggestions on ways that the Department of Revenue could become more efficient. We define efficiency as the ratio of useful work to energy expended. We will explore all the work that is done by the department and make recommendations as to how either more work could be done using the same energy or doing the same amount of work using less energy.

Before we get started with recommendations we do want to take the time to acknowledge the things that we see as great things that are being done by the department. We were able to tour the Return Processing Center and were all very impressed with their use of technology to do the important functions of receiving and processing over 10 million separate transactions per year. We also were impressed with the Motor Carrier Services, which has become the model for the entire country. We also want to take time to thank Commissioner Miller and his staff for their openness and work to get answers for all of the difficult questions that arose.

In review of the Indiana Department of Revenue's efficiency, one is left with the impression that the Department is at the cutting edge of technology in processing the 10 million plus transactions in a year's time. After interviews, a walk through of the Return Processing Center (RPC), review of the December 18, 2003 presentation to the Government Efficiency Commission and comparison to the Internal Revenue Service and the Illinois Department of Revenue, it is very apparent that this agency can absorb other collection and processing functions performed by other Departments and Agency. The Department could make other data available to the public and researchers to aid in understanding the total volume of the various tax types.

Working with Accenture, the Department has improved the processing capabilities and cost effectiveness. Concern was raised to the internal audit of the Department's operation and it was determined that this function is solely the responsibility of the Information Technology and Accenture. As explained it is team coordination between several Division with IT and Accenture providing oversight.

Interviews were conducted with Commissioner Kenneth Miller, Linda Dollens, Administrator, Larry J. Smith, Deputy Administrator and Karen Barthelmes, Quality Assurance Division. It was determined to study capacity at the RPC (Logan Facility) to see if the department's capacity could undertake the additional workload. The operation at the Logan facility was very impressive with questions answered prior to, during and after the walk through.

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The total volume of tax return processing is shown in the Excel worksheet Tax Returns by Type included in the appendix.

Both, the I.R.S. and the Illinois Department of Revenue reports on their web sites the number of returns processed for all types of Income Tax. **We recommend that the Indiana Department of Revenue do likewise.**

The processing center is only at 100% capacity for one shift during the period from March to May of each year. With the shift of the taxpayer from filing returns by paper to electronic filing the capacity to absorb other functions of processing grows. The processing center is estimated being at 50% capacity in the other months of the year. For the year 2002, the following is a comparison of the percentage of types of filing for Individual Income Taxes with the Illinois Department of Revenue.

Type	Illinois		Indiana	
Paper	4,372,434	73%	1,205,072	42%
Internet	86,881	1%	45,658	2%
PC (IL) 2D (IN)	171,232	3%	543,527	19%
TeleFile	120,963	2%	69,732	2%
Electronic	1,238,563	21%	1,205,072	35%
Totals	5,990,073		2,871,798	

Illinois Department of Revenue collects approximately 22.5 billion with an estimated expenditures of 0.9 billion. In the "Net Revenue Collections & Administrative Costs" analysis in the presentation the cost per $100 to revenue is $0.58 for Indiana and for Illinois $4.00. **Illinois Department of Revenue has responsibility over the property tax function.**

The Internal Revenue Service and the Indiana Department of Revenue cooperates in the sharing of information in regards to Income Tax filings. The Department's RPC is working with other agencies such as Workforce Development, Environmental and Department of Natural Resources, to collect various taxes and fees for those agencies. **The Department could and should undertake processing such returns as UC-1s, Licenses and Fees currently collected by other agencies.**

The countless awards that the Department has won in efficiency and improvements in the information technology field, indicates it is quite feasible for the State Government to transfer collections and processing from other areas to this Department.

A comprehensive review of Department operations was conducted in 2003 by Accenture. A summary of these results was presented to the Government Efficiency Commission in December, 2003. Accenture used a proprietary Public Sector Value (PSV) model as the analytical framework to assess performance. The model calculates cost effectiveness as a function of four key outcomes: maximizing tax revenue, maximizing compliance rates, minimizing taxpayer burden and maximizing responsiveness to taxpayers. Based on Indiana's current fiscal situation, the tax revenue and compliance outcomes were weighted more heavily (30% each) than the service-oriented outcomes (20% each). The PSV model's stated rationale for the weighting used for maximizing revenue is that "the most fundamental function of a Revenue agency is to administer tax laws fairly and efficiently by collecting appropriate tax dollars from citizens and

businesses." The stated rationale for the maximizing compliance outcome is "an increase in the number of taxpayers filing voluntarily and correctly indicates that the revenue agency is being effective with its public outreach, education, customer service and compliance programs."

Accenture found that the integrated Revenue Processing System (RPS) had improved processing and billing capabilities and this enabled the Department to increase compliance revenues by 110 percent between FY 2001 and FY 2003. Other key findings in the Accenture report were that the RPS processing capabilities had significantly reduced cycle time for issuing refunds and the time required to process retail merchant certificates. The report concluded that the Department's capital investments and budget increases had decreased the operational cost per taxpayer from $15.56 in FY 1998 to $13.79 in FY 2003.

Given the importance of the revenue and compliance maximization for Department performance, the subcommittee sought additional data that describe these functions in more detail. Through Commissioner Miller, we obtained the data input spreadsheets Accenture used in calculating the PSV statistics. Compliance revenue was less than 2.5 percent of all tax collections in 2002 but as shown in **Figure 1**, the proportion of the total is rising. **Table 1** indicates the distribution of compliance revenue collection for different tax types.

Figure 1 Compliance Revenue as a Percent of Total

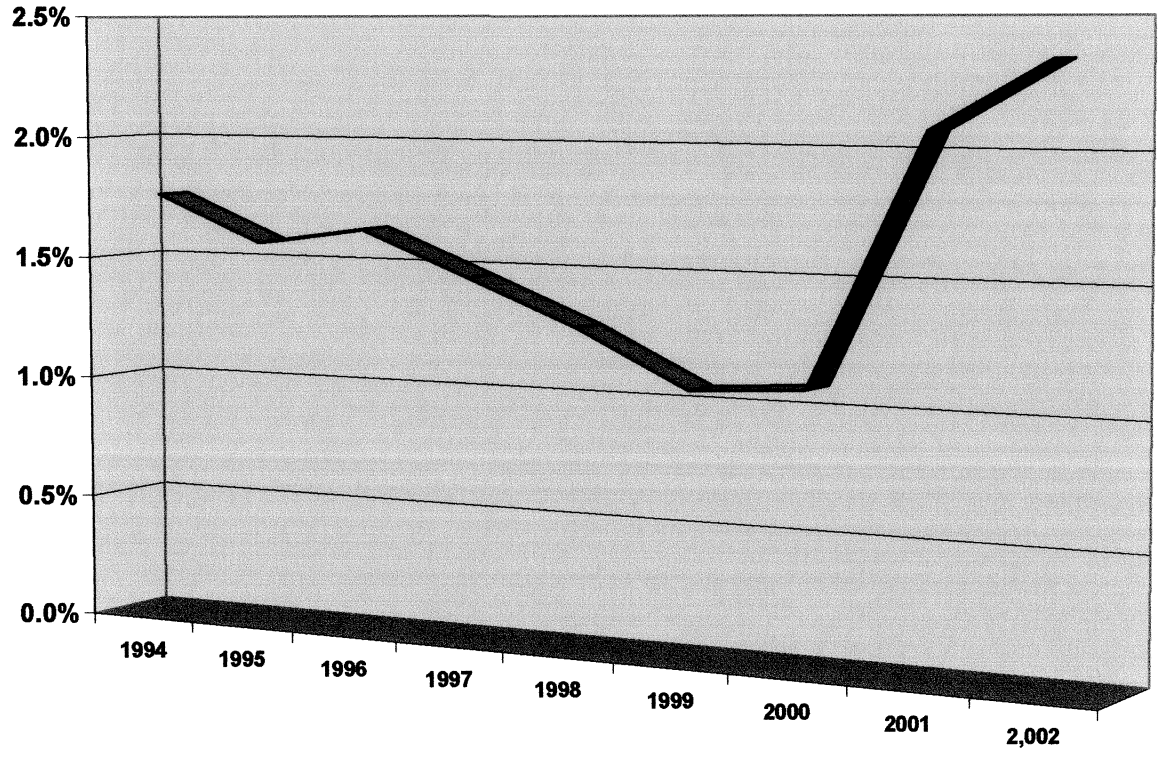
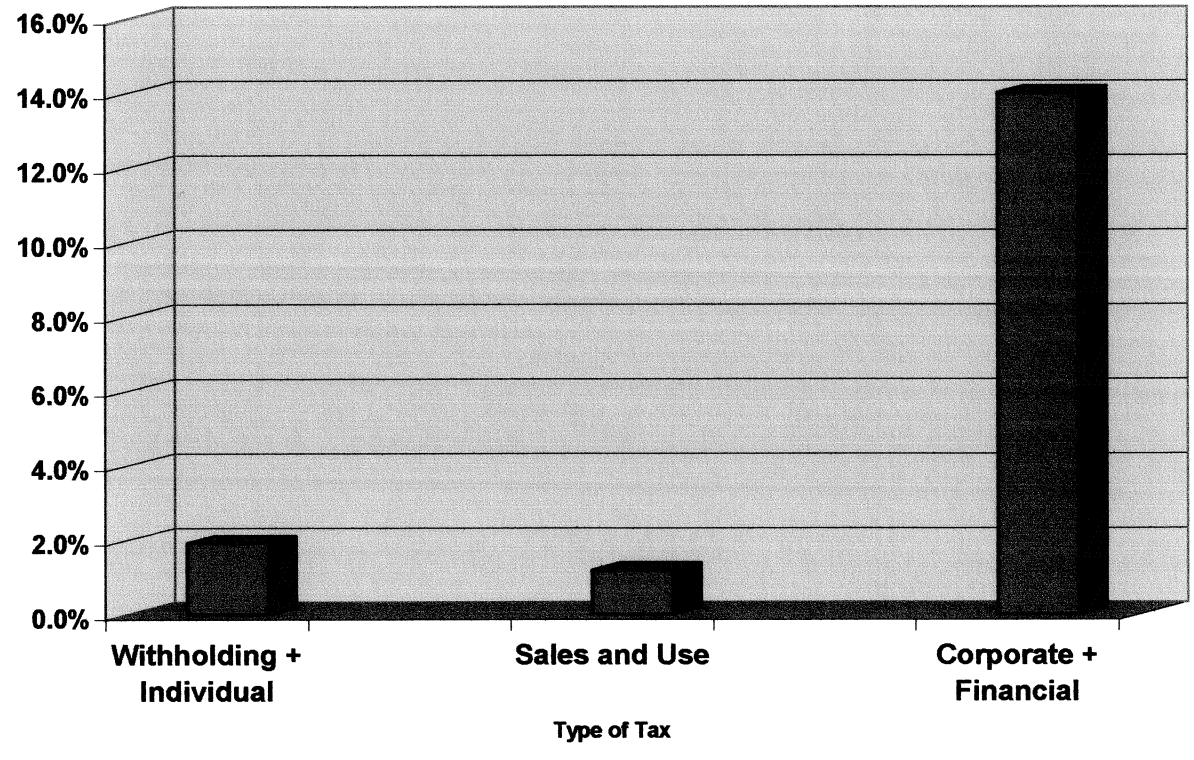


Table 1 Compliance Revenue Collection by Tax Type

	2002		2003	
Tax Type	**Amount**	**Percent of Total**	**Amount**	**Percent of Total**
Withholding	31,307,172	15.6	31,156,500	14.3
Individual	58,255,946	29.0	56,707,717	26.1
Sales and Use	55,991,394	27.9	50,224,553	23.1
Corporate	41,362,368	20.6	64,595,473	29.7
Financial Inst.	7,120,881	3.5	6,367,259	2.9
Not specified (non-PSV taxes)	6,961,401	3.5	8,436,658	3.9
Total compliance revenue	200,999,163		217,488,160	

The total number of corporate returns filed is small [see Returns by Tax Type in **Appendix**] but corporate tax collections accounted for 29.7 percent of total compliance revenue across all tax types. As shown in Figure 2, compliance action accounted for 14% of all corporate tax revenue. This result is attributable, in part, to errors based on the scope and complexity of corporate tax filings but there are possible tax equity considerations as well since compliance may be affected by a host of other factors [see Recommendation 4]. The Department tracks citations for 77 separate sections of the Indiana tax code for adjusted gross income tax violations and 40 sections for gross income tax violations. Figures showing income tax violations by industry group are included in the Appendix. The data, drawn from the Department's 2003 Annual Report, also show violations of Indiana code for sales and use tax.

Figure 2 Percent of Total Compliance Revenue Collected by Tax Types



The Department tracks citations involving 110 code sections for sales and use tax. Individual occurrences of code violations number in the hundreds for each industrial group. The 2003 Annual Report compliance section lists recurring problems, related to paperwork errors such as failure to complete forms properly. The volume of sales and use tax transactions no doubt exacerbates these problems and contributes to the relatively high proportion of late filings in this category [see Figure 3]. It must be noted, however, that equity factors might also be a factor. As shown in Figure 4, delinquencies are relatively high for both sales and withholding tax payers.

Figure 3 Percent of Late Returns by Tax Type

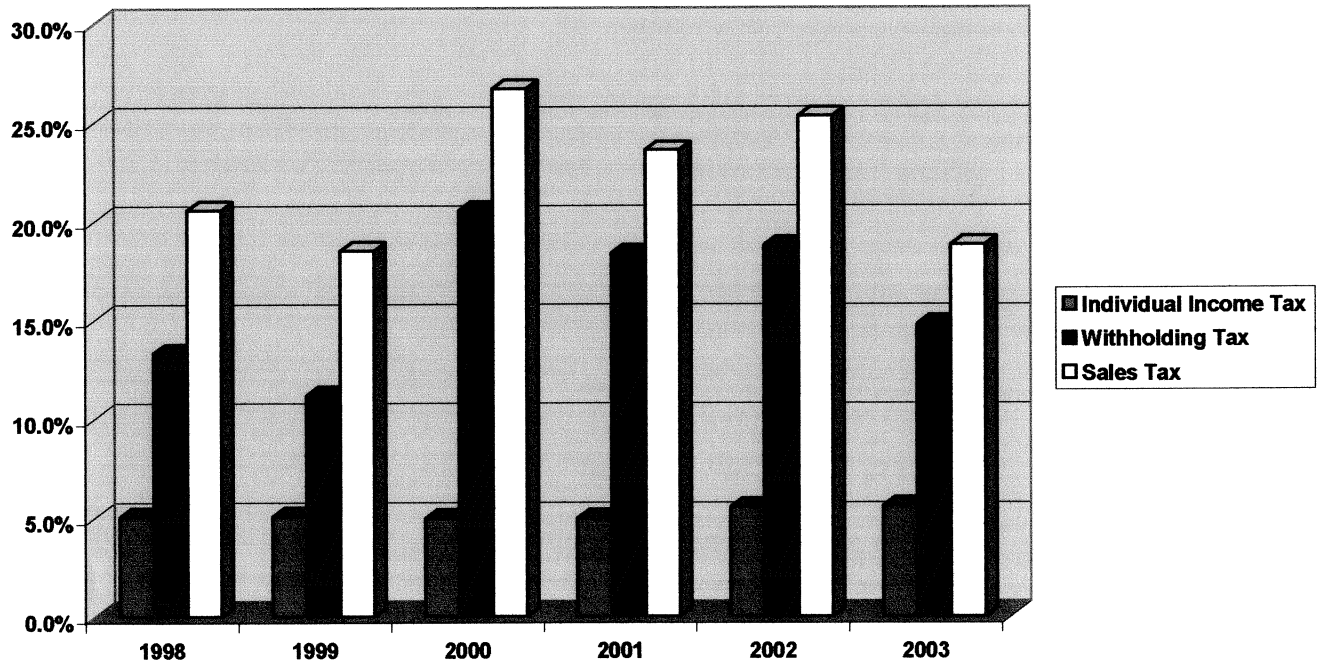
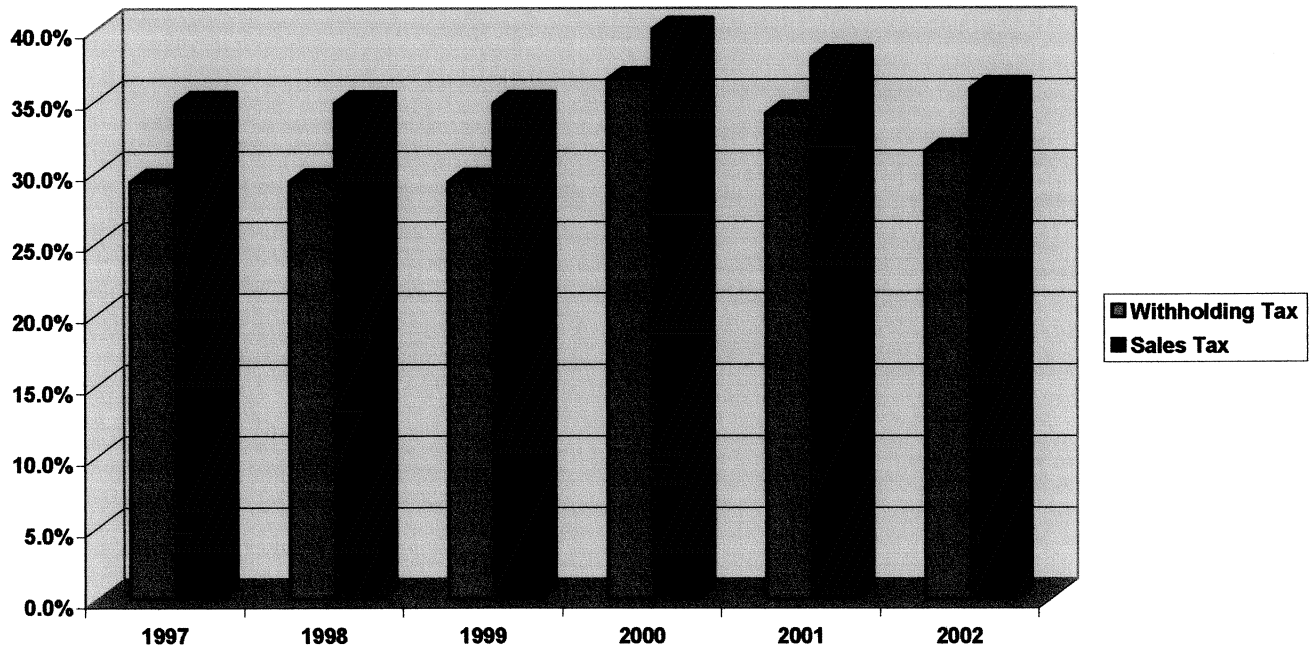


Figure 4 Percent Delinquent Taxpayers by Tax Type



Recommendation #1:

There are well known equity considerations inherent in the imposition of sales and excise taxes. The distribution of the tax burden as a share of income is considered "regressive." Those at the low end of the income scale pay a greater proportion of their income than those earning more. These taxes also raise efficiency considerations in that individual businesses are responsible for performing a tax collection function on behalf of consumers and the state. Unlike reporting and remitting withholding taxes that arise out of the employment relationship, businesses are essentially a third party in this tax collection function. **Elimination of the state sales tax and a revenue neutral substitution in some other form would certainly improve the efficiency of the Department's operations and reduce the paperwork burden now imposed on businesses.**

The limited areas of concern that were expressed earlier may be easily addressed by the Department. Other concerns are the collection of taxes from sophisticated taxpayers such as large businesses who operate in this state. In reading the Annual Report of the Illinois Department, it not only stated number of returns by type but also address the loopholes and aggressive approaches they were taking to collect the appropriate tax due from these taxpayers. The Department states the $273.8 million is delinquent, but we are not informed as to the type of taxpayer that is delinquent. In the Indiana Division Statistical Study for Fiscal Year 2002, the most frequent violations of Income Tax, Sales/Use Tax, Corporate Adjusted Income Tax and Miscellaneous Code Violations are also from these taxpayers.

Recommendation #2:

Serious consideration should be given to creating a Division of Local Government Revenue in the Department of Revenue, eliminating the Department of Local Government Revenue as a self-standing state agency.

Rationale: By incorporating the Department of Local Government Revenue into the Department of Revenue, there should be the potential for significant savings through the elimination of duplicate overhead functions (such as payroll, human resources, and financial management operations). In addition, there should be opportunities to realize savings through synergies in the area of information technology, legal counsel, policy analysis, legislative advocacy, and other areas.

Approximately 32 states and the District of Columbia combine their "property tax agency" with their department of revenue.[1] These states include: Alabama, Alaska, Arizona, Florida, Georgia, Idaho, Illinois, Iowa, Kansas, Kentucky, Maine, Massachusetts, Minnesota, Mississippi, Montana, Nevada, New Jersey, New Mexico, North Carolina, North Dakota, Ohio, Oklahoma, Oregon, South Carolina, South Dakota, Texas, Utah, Vermont, Washington, West Virginia, Wisconsin, and Wyoming. Indiana is in the minority of approximately 14 states that have separate property tax and revenue departments. These states include: Arkansas, California, Colorado, Connecticut, Indiana, Louisiana, Maryland, Michigan, Missouri, Nebraska, New Hampshire, New York, Pennsylvania, and Tennessee.[2]

Finally, it can be argued that a major justification for maintaining a separate state agency was eliminated when the State Board of Tax Commissioners was divided into two entities – the Department of Local Government and the Board of Tax Review. No longer is appeals part of the responsibility of the "property tax agency" leaving the Department of Local Government Finance with many responsibilities that are similar to those of the Department of Revenue.

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Caveats:
Opposition from treasurers/ elimination of elected office functions

Recommendation #3:

Consolidate the property tax assessment function by reducing the number of assessing districts and elected assessing officials from 1,100 (1,008 townships 92 counties) to 92 assessing districts.

Rationale: Over time the assessing function has become more sophisticated requiring professional expertise and training to do a suitable job determining the basis for property taxation, the assessed value. With the elimination of true tax value and the adoption of market value as the standard of value, the importance of having professionally trained, full-time assessors has increased. Consolidation of assessing responsibilities into the county assessor's office in each of Indiana's 92 counties will make it more reasonable for the Department of Local Government Finance to increase the educational requirements required for those elected as assessors and for those working in the assessor offices. In addition, economies of scale should be realized through better coordination and the elimination of duplication of effort and accountability will be enhanced as there will be one person responsible for the assessing function in a county instead of a number of individuals.

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[1] This list was compiled by a research assistant for Professor Kurt Zorn, based on an internet search of state agencies.
[2] The research was inconclusive concerning the status of the property tax operations for Delaware, Hawaii, Rhode Island, and Virginia.

Recommendation #4:

Adopt the following recommendations pertaining to the restructuring of local government contained in the Indiana Project for Efficient Local Government Study:

- "The funding and provision of poor relief services to be shifted to county government. Local ports of delivery should be maintained where possible."
- "Consistency is the key to successful real property assessment. Property assessment should be removed as a township function and assigned to the county. Counties should then have the ability to coordinate with other counties to have property assessment occur on a regional basis."
- "Where a municipality completely envelops the full geographic area of a township, the township should be dissolved and the municipality and/or county should assume the remaining functions of the subsumed township."
- "Technological and communication advancements today allow for combining of recorder, clerk, treasurer and auditor functions." This study calls for creation of a Department of Finance and Administrative Services. Three divisions within this department would include:
    - Property management – combining assessing and property tax administration duties of the assessor and auditor with some property recordkeeping functions of the recorder.
    - Fiscal management – combining financial responsibilities of the auditor and treasurer. Technological advancements and auditing standards allow these functions to be performed within the same office.
    - Administration – a new division designed to improve both internal and external efficiencies. Addition of a public information officer and coordination of a technological network will provide more effective service to the public."
- "The office of county surveyor should be eliminated."
- "Counties should be permitted to implement the form of government that best serves their needs."
- "Counties should be permitted and encouraged to share in the capital and operating costs of a multi-county correctional facility. By allowing counties to build, operate and maintain a multi-county correctional facility, counties may explore innovative ways of lessening the burgeoning costs correctional facilities place on county budgets."
- "In executing police and fire safety functions, both police and fire administrators should engage in joint purchasing with other police and fire units in the area."
- "Because adequate fire and police protection requires a substantial investment in equipment, local firefighters and police officials representing all types of jurisdictions shall collaborate with the appropriate agencies, including the Indiana Department of Administration, to develop standards for the creation of a Quantity Purchase Award program for fire and police protection and emergency services equipment."
- "Local units of government should be encouraged to institute the use of administrators and/or managers to streamline administrative and clerical functions."
- "City and town clerk-treasurers should be an appointment of the executive and not an elected office."
- "In a second-class city with no court, city clerk functions are primarily limited to recordkeeping and clerical duties. An elected official is not required. These duties should be reassigned to other departments"
- "To promote savings in the provision of fire services, the state fire marshall shall establish standards for acceptable fire coverage (e.g. standard response time). Local fire departments shall create fire service territories to meet the state fire marshall's standards for coverage."

Rationale: Details about the recommendations and supporting rationale are contained in the report which can be found at the following URL:
http://www.indianachamber.com/pdf/CompeteStudy/2004_Compete_Full_Report.pdf

The executive summary can be found at:
http://www.indianachamber.com/pdf/CompeteStudy/2004_Compete_Exec_Summary.pdf

Recommendation #5:

In the process of looking at the tax amounts that come into the Department of Revenue one of the glaring reductions was in the column of Corporate Taxes. From 2000 to 2003 corporate tax dollars dropped from $1 billion to around $700 million. That is close to a $300 million drop in just three years. The decision was made that we would investigate why the drop was so great.

Our first look was into whether business was just down in Indiana. Looking at the Sales Tax Collection numbers we would say that is not the only reason for the reduction in Corporate Taxes. Sales Tax Collections have gone up about $500 million in that same three year time frame. Sales Tax collections in the State of Indiana are up to 4.2 billion dollars. Part of this is due to the increase in State Sales Taxes.

While researching other reasons for the slump in Corporate Tax Collections we carefully reviewed a study done by Michael Mazerov of the Center on Budget & Policy Priorities. **Since this state and others treat Corporate Taxes as such a highly confidential source of information we cannot give you the TOTAL actual names and amount of tax dollars diverted from the state tax rolls.** The Center on Budget & Policy report "Closing State Corporate Tax Loopholes" absolutely offers factual documented reasons as to why Indiana's Corporate Tax Revenue has been decreasing. **The Task Force on the Department of Revenue discussed the Center on Budget & Policy report with Commissioner Miller and he confirmed that Indiana is losing millions of dollars of tax revenue every year to Companies that have set up these Delaware Holding Companies (DHC's). He told us that fiscal year 2003 there were 112 audits and that Indiana lost $70 million. In 2004 there were 79 audits and Indiana lost $56.6 million. This is a total of $126 million in just two years. Looking at Indiana's current financial situation, $126 million could be put to good use.**

A quick fix to this problem is to amend state law to deny deductions for royalty/interest payments to DHC subsidiaries in tax haven states. This has already been done in 7 states, including Ohio. **A more lasting fix to this issue is to amend the law to switch state corporate income tax to "combined reporting". This treats parent and subsidiaries as one corporation for tax purposes; therefore, no benefit to shifting income to DHC's. This has been done in 16 other states.**

The current economic downturn has opened up enormous gaps between revenues and expenditures in the budgets of the vast majority of states. Tax revenues are flat or declining, and spending pressures are growing as families with unemployed workers require state-financed medical assistance and income support. New spending demands associated with security and public health concerns are compounding the states fiscal crises.

As they work to close these budget gaps, state policymakers are facing difficult decisions about whether to cut state services and/or raise taxes. In particular, they may wish to scrutinize their tax structures for unintended and unrecognized loopholes that allow some individuals and businesses to avoid paying their fair share of taxes, and then take steps to minimize such tax-avoidance opportunities.

The Corporate Income Tax Is a Fading Source of State Revenue

State corporate income taxes are long overdue for a thorough examination. The corporate income tax laws of the majority of states are riddled with loopholes that permit many large multistate corporations to avoid paying tax on a significant share of their profits. The growing sophistication of corporations in exploiting these flaws has undoubtedly contributed to the declining significance of the corporate income tax in state tax structures over the past two decades. According to the U.S. Census Bureau, corporate income taxes supplied 10.2 percent of state tax revenue in the states levying them in 1979, but just 6.3 percent in 2000.

The steady erosion of state corporate income taxes is revealed as well in estimates of the effective state corporate income tax rate. The effective corporate tax rate is the rate at which corporations actually pay tax on their profits, as opposed to the rate that is nominally imposed. The effective corporate tax rate is measured by dividing actual corporate tax collections by an estimate of true corporate profits. Top nominal state corporate tax rates are generally in the range of 6-10 percent; only five of the 45 states imposing corporate taxes (including the District of Columbia) have top nominal rates less than 6 percent. A recent report by the Congressional Research Service estimated, however, that the average effective state corporate income tax rate declined from 5.3 percent in 1979 to 3.8 percent in 1998.

During the strong economic expansion of 1995-2000, state corporate income tax revenue grew at just half the rate of federal corporate tax revenue — an average of three percent annually versus six percent annual growth for the federal corporate income tax.

Closing Common Loopholes Could Help Stem the Erosion of the State Corporate Tax

The loopholes could be closed without having to make fundamental changes in the structure of the corporate tax, additional revenue could begin flowing relatively quickly, and a substantial share of the additional revenue would arise from the taxation of corporate profits that currently are escaping taxation completely.

- Enacting laws to nullify a corporate tax-avoidance strategy based on the use of passive investment company (PIC) subsidiaries, such as the well-known Geoffrey, Inc. subsidiary of Toys R Us. Such laws prevent corporations from using payments of royalties and interest to PIC subsidiaries to siphon taxable income out of the states in which the income is actually earned and into tax haven states like Delaware and Nevada.

- Amending the definition of apportion able business income to strengthen the ability of states to tax capital gains realized on the sale of corporate subsidiaries and other major assets, reversions from over-funded pension plans, damage awards in lawsuits, and other irregular or extraordinary income items.

Implementing these policy changes could make a meaningful contribution to closing current gaps between revenues and expenditures and help stem the long-term erosion of the corporate tax base. Each of these policies has already been implemented in approximately half the states levying corporate income taxes. None are mutually exclusive or overlapping; any or all of them can be implemented in states that have not yet done so.

Closing the Trademark Income-Shifting Loophole

Many major corporations have implemented a corporate income tax avoidance strategy that is based on transferring ownership of the corporation's trademarks and patents to a subsidiary corporation located in a state that does not tax royalties, interest, or similar types of intangible income. The subsidiaries often are referred to as passive investment companies PIC's and they are most often established in Delaware and Nevada. (Delaware has a special income tax exemption for corporations whose activities are limited to owning and collecting income from intangible assets. Nevada does not have a corporate income tax at all.) Profits of the operational part of a business that otherwise would be taxable by the state(s) in which the company is located are siphoned out of such states by having the tax-haven subsidiary charge a royalty to the rest of the business for the use of the trademark or patent. The royalty is a deductible expense for the corporation paying it, and so reduces the amount of profit such a corporation has in the states in which it does business and is taxable. Moreover, the profits of the PIC often are loaned back to the rest of the corporation, and a secondary siphoning of income occurs through the payment of deductible interest on the loan.

It is not possible to obtain a comprehensive picture of how much otherwise taxable profit is being shifted into tax haven states through the use of PIC's, because the information is confidential. Corporations do not have to flag particular subsidiaries as being PIC's nor publicly disclose payments of royalties and interest to affiliated corporations. Data gleaned from individual court cases in which PIC arrangements have been challenged by state tax officials suggest, however, that the sums involved may be enormous:

- The Delaware PIC of Toys R Us received $55 million in royalty and other passive income in 1990 by charging the company's stores for the use of the Toys R Us name, trademarks, and merchandising skills.

- The Delaware PIC's of the Limited/Victoria's Secret/Lane Bryant/Express retail conglomerate earned $949 million in royalty income between 1992 and 1994 by licensing the companies respective trademarks back to the stores.

A wide variety of financial, law, accounting, and consulting firms have made a major business of helping out-of-state corporations set up and operate PIC's in Delaware and Nevada. An article by an investigative reporter a number of years ago indicated how little economic substance many of the PIC's established by the Delaware PIC industry appear to have:
On the 13th through the 18th floors of the1105 N. Market St. office tower are more than 700 corporate headquarters. How do 700 corporate headquarters squeeze into five narrow floors? How do 500 fit on the 13th floor alone? Because all they've done is bought the Delaware address.

Thanks to the ready availability of brass plate headquarters, passive investment companies can provide enormous state corporate income tax savings at a very small cost. Accordingly, it seems likely that a majority of large U.S. corporations have created PIC's. As of the end of 1998, approximately 6,000 PIC's had been incorporated in Delaware alone, with new ones being created at a rate of 600-800 per year. It was recently revealed that there are approximately 132,000 businesses incorporated in Nevada that have no employees; many of these could be PIC's. A recent Wall Street Journal article on PIC's named 50 corporations that have been involved in litigation with states regarding their use of PIC's .

The states levying corporate income taxes can be broken down into three categories with respect to their vulnerability to PIC's as a corporate tax avoidance mechanism:

- The corporate tax systems of approximately one-third of the corporate income tax states — Alaska, Arizona, California, Colorado, Hawaii, Idaho, Illinois, Kansas, Maine, Minnesota,

Montana, Nebraska, New Hampshire, North Dakota, Oregon, and Utah — are not vulnerable to the PIC tax shelter. These states effectively require corporations to add together for tax purposes the profits of the tax haven subsidiary and the corporation(s) paying the royalties and interest. This policy, called combined reporting, is the most comprehensive approach to nullifying a wide variety of corporate tax-avoidance techniques, including PIC's.

• Seven states — Alabama, Connecticut, Massachusetts, Mississippi, New Jersey, North Carolina, and Ohio — have enacted laws that directly address artificial income shifting through the use of PIC's. In slightly different ways, all seven states simply deny a deduction from gross income for royalties and interest paid to related corporations.18

• The other 22 corporate income tax states — Arkansas, Delaware, Florida, Georgia, Indiana, Iowa, Kentucky, Louisiana, Maryland, Missouri, New Mexico, New York, Oklahoma, Pennsylvania, Rhode Island, South Carolina, Tennessee, Texas, Vermont, Virginia, West Virginia, and Wisconsin — and the District of Columbia could realize additional corporate income tax revenue if they adopted combined reporting or enacted laws modeled on those of Alabama, Connecticut, Massachusetts, Mississippi, New Jersey, North Carolina, and Ohio to shut down this widespread, abusive, and costly tax avoidance technique. A state could adopt Massachusetts-style laws as a quick fix for the PIC problem and then move to the more comprehensive solution of combined reporting over the subsequent year or so.

Which Corporations Are Known to Have PIC Subsidiaries?

A recent Wall Street Journal article identified 50 corporations that have been involved in litigation with states regarding their use of passive investment companies. The article observes that "in every case, the companies contend they haven't violated state tax laws or regulations." The companies are:

Aaron Rents
ADP, Inc.
American Greetings Corp.
Beatrice
Budget Rent-a-Car Corp.
Burger King
CompUSA
ConAgra Foods, Inc.
Crown Cork & Seal
Dover Elevator
Dress Barn
Eaton Admin Corp.
Gap, Inc.
Gore Industries
Hologic, Inc.
Home Depot USA
Honeywell International, Inc.
J.P. Stevens and Co.
Kimberly Clark Corp.
Kmart Corp.
Kohl's
Lamb Weston, Inc.
Long John Silver's

McCormick & Co.
Mallinckrodt Medical
Marsh Supermarkets, Inc.
Marsh Village Pantries, Inc.
May Dept. Stores
Novacare
Payless Shoesource, Inc.
PF Brands, Inc.
Premark FEG Corporation
R. Scientific Products
Radio Shack Corp.
Sherwin Williams
Snap on Tool
Sonoco Products Co.
Stanley Works
Staples
Sunglass Hut International, Inc.
Syms
The Limited Brands
TJX Cos.
Toys R Us
Tyson Foods, Inc.
United Refrigeration of Del.
Urban Outfitters
Yellow Freight System
York International

Source: Glenn R. Simpson, "A Tax Maneuver in Delaware Puts Squeeze on Other States," Wall Street Journal, August 9, 2002. page A-1.

Expanding the Definition of Taxable Business Income to Encompass Corporate Profits from Irregular Transactions

U.S. Supreme Court decisions have long made clear that the entire profit of a corporation is not necessarily subject to division by formula among all the states in which the corporation is doing business. Certain items of income must be assigned or allocated to a particular state for taxation. An example of such an allocable income item would be the interest earnings on a pool of cash being held for future corporate acquisitions rather than being used as working capital in ongoing business operations. Non-apportion able income items generally are to be assigned for tax purposes to the state in which corporate employees manage the asset(s) generating the income — often the corporate headquarters state.
In recognition of these Supreme Court decisions, most state corporate income tax laws make an explicit distinction between the share of a corporation's total profit that is business income and the share that is "nonbusiness income". "Business income" is that portion of a corporation's annual profit that is to be divided by formula among all the states in which the corporation is taxable; "nonbusiness income" is the portion to be assigned to a particular state for taxation. Under the most common definition used by states, "Business income" means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations. "Nonbusiness income" simply is defined as all income other than "business

Income."

Although it might not be apparent to someone not looking for tax-avoidance opportunities, this definition of "business income" has provided aggressive corporations with an enormous loophole they have used to deny many states their fair share of tax on billions of dollars worth of corporate profits. Since the definition provides that in order to constitute business income the income must "aris[e] from transactions and activity in the regular course of the taxpayer's trade or business," corporations have convinced numerous state courts that any profit earned on the disposition of property that is an irregular transaction is "nonbusiness income." States that year after year have allowed corporations to deduct from taxable income depreciation expenses for plant and equipment have found themselves blocked from taxing the capital gain realized when the plant and equipment was sold.

The financial damage to states flowing from the poor wording of the standard definition of business income likely extends far beyond the loss of revenue at stake in specific cases that states have lost in court. Corporations have won court cases in enough states that many probably have been emboldened to treat extraordinary profit items as nonbusiness income even in states in which no such cases have been decided. These corporations gamble that most states in which they are doing business will be reluctant to initiate costly litigation aimed at establishing that the income is apportion able business income. Moreover, corporations are given a powerful incentive to assert that extraordinary income items are nonbusiness income by the fact that about a dozen states do not fully tax nonbusiness income items they would be entitled to tax in their entirety.

A 1992 decision reiterated the U.S. Supreme Court's longstanding position that not all corporate income is subject to formula apportionment. Nonetheless, the decision made clear that states may include in corporate profits subject to formula apportionment many of the irregular income items that corporations are asserting to be nonbusiness income under the traditional state law definition. The Court held that states are free to include in apportion able income the profit associated with any asset that serves an operational function. (For example, such a standard generally would allow a state to include in apportion able business income the profit realized on the sale of a corporate subsidiary that was actively managed by the parent corporation at the time of sale.) Accordingly, leading state tax scholar Walter Hellerstein recently has advised states to bring their corporate tax laws into alignment with this Supreme Court decision through the simple device of amending the definition of business income to read:
"Business income' means all income which is apportion able under the Constitution of the United States."

- Some 26 states — Alabama, Alaska, Arizona, Arkansas, California, Colorado, Hawaii, Idaho, Illinois, Indiana, Kansas, Kentucky, Louisiana, Mississippi, Missouri, Montana, New Mexico, New Jersey, New York, North Dakota, Ohio, Oregon, Tennessee, Utah, West Virginia, and Wisconsin, and the District of Columbia could ensure that they obtain their fair share of corporate income tax revenues from irregular corporate transactions by amending their statutes to define as apportion able income all income that they are permitted to apportion under U.S. Supreme Court standards. — as recommended by Professor Hellerstein.

Will Closing Corporate Tax Loopholes Impede a State's Economic Development?

Whenever a state contemplates increasing taxes on businesses through any mechanism, one question almost always arises: will this hurt the state's economy by driving existing businesses away or making the state a less desirable location for future business investment and job creation?

A large body of research suggests that a state's business tax structure — including the design of specific taxes and the aggregate tax burden — has at most a small impact on a state's economic fortunes. Many of these studies look at the impact of state and local business taxes on business formation assuming that all other differences among states that potentially affect economic development — such as the quality of public services, the availability of an adequately-trained labor force, and the cost of energy — are being held constant. In reality, differences in these factors among states can be significantly greater than differences in tax burdens and thus have a much greater impact on the relative attractiveness of different states as a location for new business investments.

Robert Tannenwald, an economist with the Federal Reserve Bank of Boston, conducted one of the more recent studies of the effect of state tax policy on economic development. Tannenwald's study looked at the impact on manufacturing investment in five industries of total state business tax burdens, after controlling for other non-tax factors that seem likely to affect business location decisions. The study measured interstate variation in business tax burdens in a particularly careful and rigorous way. For the 22 states in the study — which included most of the major manufacturing states — Tannenwald found no statistically significant correlation between business tax burdens and the location of new investment. If — as in Tannenwald's study — total business tax burdens do not seem to have a significant impact on business location decisions, policymakers should be even less concerned that closing a few loopholes in just one tax would adversely affect their state's economic development. According to research by Ernst and Young economists Kevin Christensen, Robert Cline, and Thomas Neubig, state corporate income taxes account for only about 10 percent of total state and local taxes paid by corporations. Thus, even if one accepted the premise that interstate differences in business tax burdens affect business location decisions, the corporate tax alone seems unlikely to be a major factor. Moreover, if enacted, the policy changes discussed in this report likely would affect a minority of corporate taxpayers in most states.

Enacting the loophole-closing measures discussed in this report seems particularly unlikely to adversely affect a state's attractiveness as a place to retain or locate investment and jobs. The possible change in the definition of apportion able business income addresses state taxation of the profit realized on major, irregular corporate transactions — such as lawsuit awards, and the sale of corporate subsidiaries. Since such transactions are infrequent and largely unpredictable, it seems quite unlikely that corporate location decisions would be affected by how extensively the profits from them would be taxed in a particular state should they occur. With respect to the other options discussed — combined reporting and nullifying the use of PIC's — there is some objective evidence that the policies do not seem to harm the economic fortunes of states implementing them.

As discussed above, there are compelling policy arguments in favor of states preventing corporations from siphoning profits into tax havens through the use of PIC's, and adopting an expansive definition of apportion able business income. If all states with corporate income taxes took these arguments to heart and implemented these policies, then by definition no state would be at a competitive disadvantage for having done so. Each of these options has already been adopted by approximately half of the states. The remaining states can implement them secure in the knowledge that they will not be identifying themselves as an "outlier" with respect to their corporate tax practices, let alone objectively harming their economic prospects.

Why These Particular Loopholes May Warrant High-Priority Attention

There are a number of reasons these three particular corporate tax loopholes may warrant higher-priority attention from policymakers than other potential changes in state corporate income tax laws that also could raise additional revenue for states.

* As measured by corporate tax revenue foregone, it seems likely that these provisions are among the most costly loopholes in state corporate tax systems.

* Each of these loopholes can be closed easily, without any alteration of the basic structure of a state's corporate tax. Indeed, amending the definition of apportion able business income — usually involve adding or modifying a single sentence of text in the corporate tax law.

* Making these changes in corporate tax law is likely to begin generating additional revenue fairly quickly. There is relatively little ambiguity involved in what the changes require of corporations and thus relatively little discretion for corporations to interpret the new provisions in ways that would allow them to mitigate the impact of the changes on their tax liability. Because the changes are relatively straightforward, corporations are likely to comply on their own rather than being compelled to comply by an audit and, perhaps, litigation. As a result, states may well begin to receive additional revenue from these changes in the first quarterly estimated tax payments made by corporations after the changes go into effect.

Finally, these changes enable states to pull into their corporate tax bases profits that currently are avoiding taxation completely. This is inherently true with respect to enacting and eliminating the deduction for royalties and interest paid to related corporations in "tax haven" states. It is also likely true of the other proposed change — adopting a more expansive definition of apportion able "business income."

Revitalizing the corporate income tax is likely to be a long-term project for most states, requiring numerous small reforms as well as fundamental changes in the underlying structure of the tax. The current fiscal crisis provides an opportunity and an incentive for states to take some important first steps down this path. The corporate tax loopholes discussed in this report are among the most egregious provisions of any state tax. All corporations benefit when states educate their future employees, protect their property, maintain the roads they use to get their products to market, and provide the court systems that adjudicate their contract disputes. **Before state policymakers deprive citizens of vitally-needed services or ask current taxpayers to pay higher taxes to close current budget gaps, they hopefully will make sure that all corporations are paying their fair share of the cost of state services that make an essential contribution to corporate profitability.**

"Combined Reporting" Is a Comprehensive Solution to PIC's and Other Corporate Tax-avoidance Strategies

There is a comprehensive way to nullify artificial income-shifting strategies used by corporations: mandatory "combined reporting." **If a state requires combined reporting, all related corporations that are operated as a single business enterprise, any part of which is being conducted in the state, are essentially treated as one taxpayer for apportionment purposes.** For example, if a parent corporation owns dairy farms and a cheese processing plant in Wisconsin, a mail-order subsidiary in South Dakota that sells the cheese, and a subsidiary that operates retail stores throughout the United States that also sell the cheese, the profits of all three related corporations would be added together and apportioned to Wisconsin using its normal apportionment formula if Wisconsin required combined reporting. If one or more of these

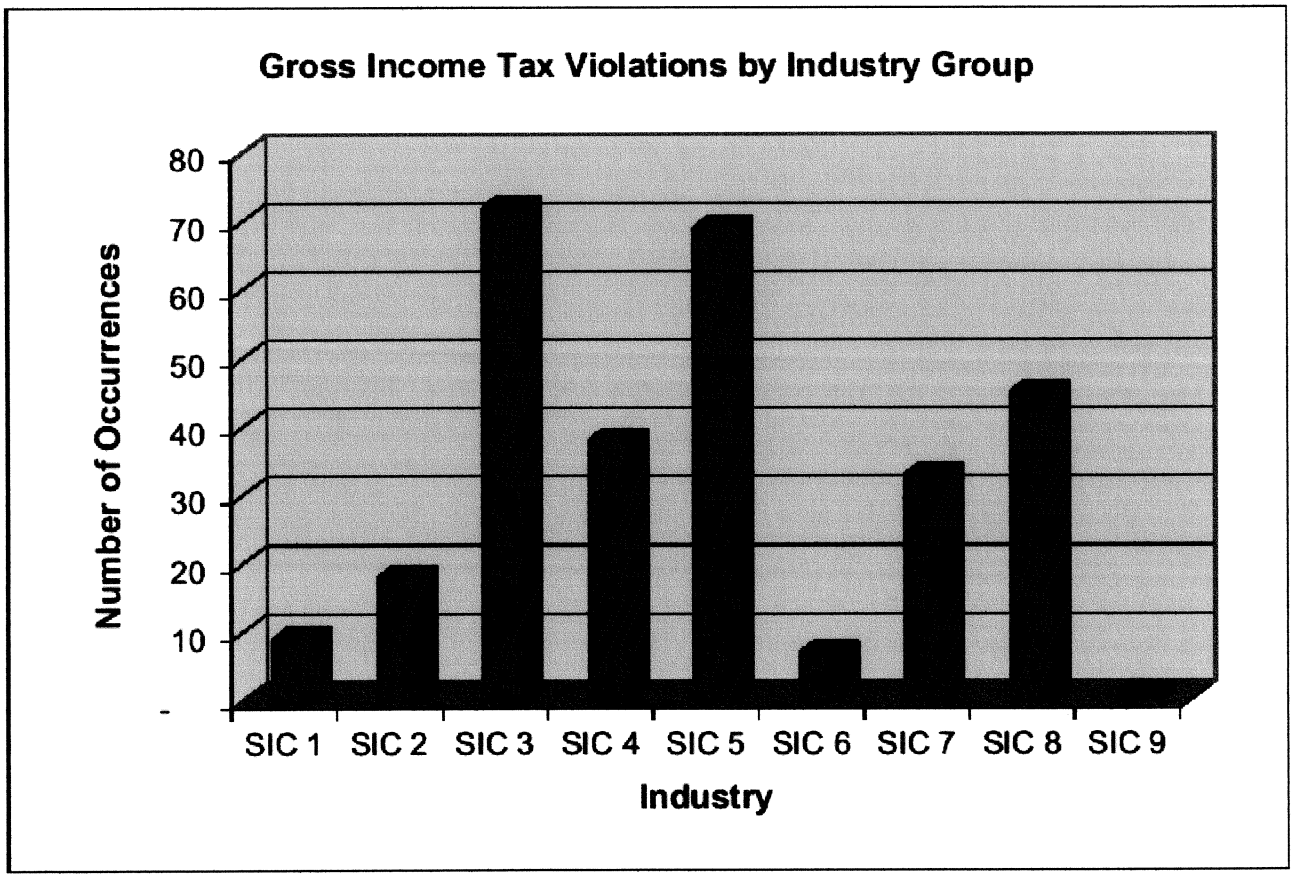
corporations owned a PIC, the PIC(s) would be included in the combined report as well. Because combined reporting requires corporations to add together the profit of related businesses before the combined profit is subjected to formula apportionment, the corporation gains little or no advantage by shifting the profit between the various corporations in the corporate group — through PIC's or any other mechanism. Sixteen states currently require corporations to determine their state income tax liability using combined reporting — Alaska, Arizona, California, Colorado, Hawaii, Idaho, Illinois, Kansas, Maine, Minnesota, Montana, Nebraska, New Hampshire, North Dakota, Oregon, and Utah. The U.S. Supreme Court has twice upheld the fundamental fairness and constitutionality of combined reporting as a means of nullifying accounting manipulation by corporations and ensuring they pay their fair share of the costs of state government.

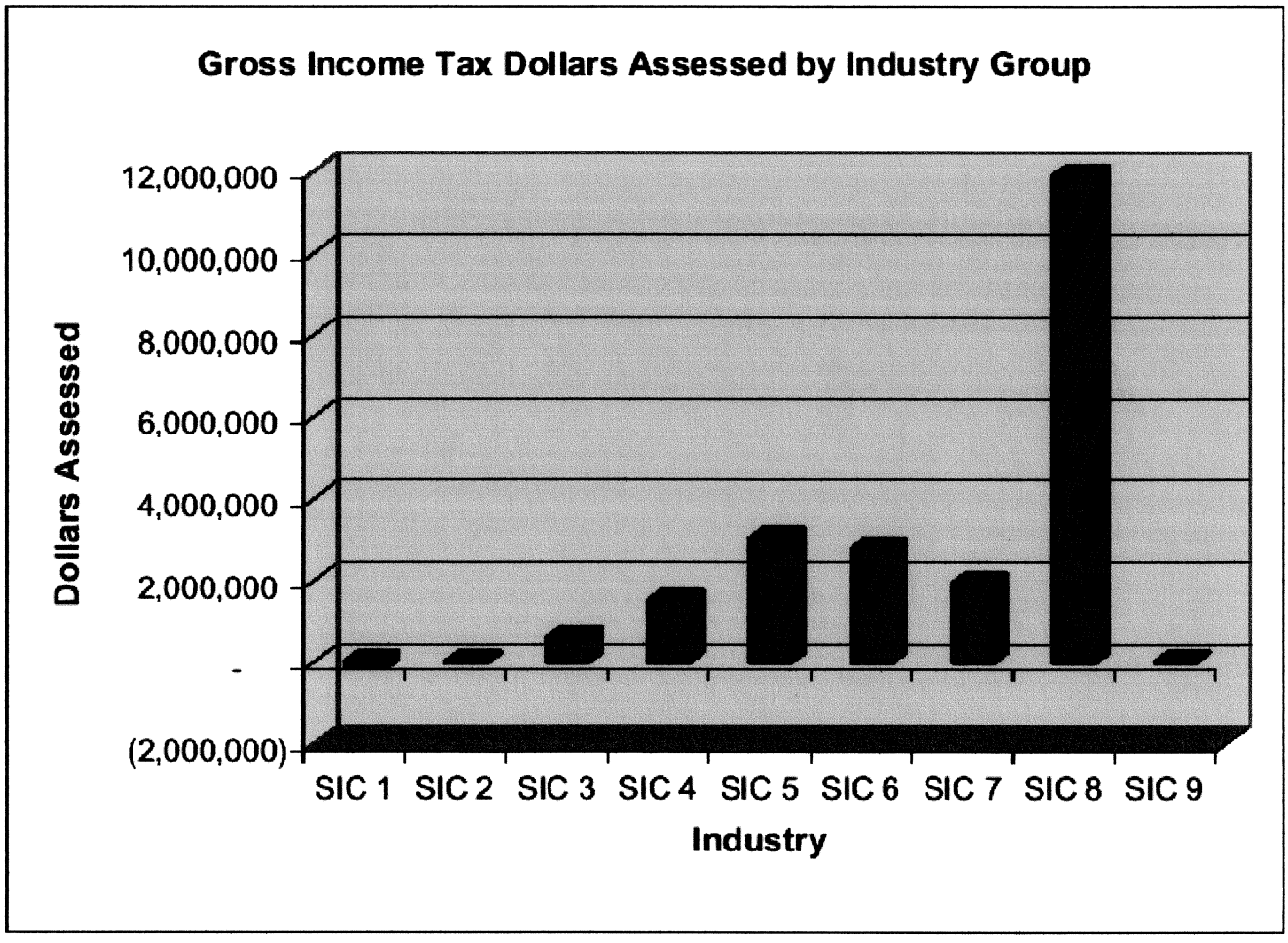
Combined reporting is a more comprehensive long-term solution to the PIC problem. However, combined reporting does represent a significant change in the structure of a state corporate tax that heretofore has been based on the concept that every individual corporation in a multi-corporate group is taxed as a "separate entity."

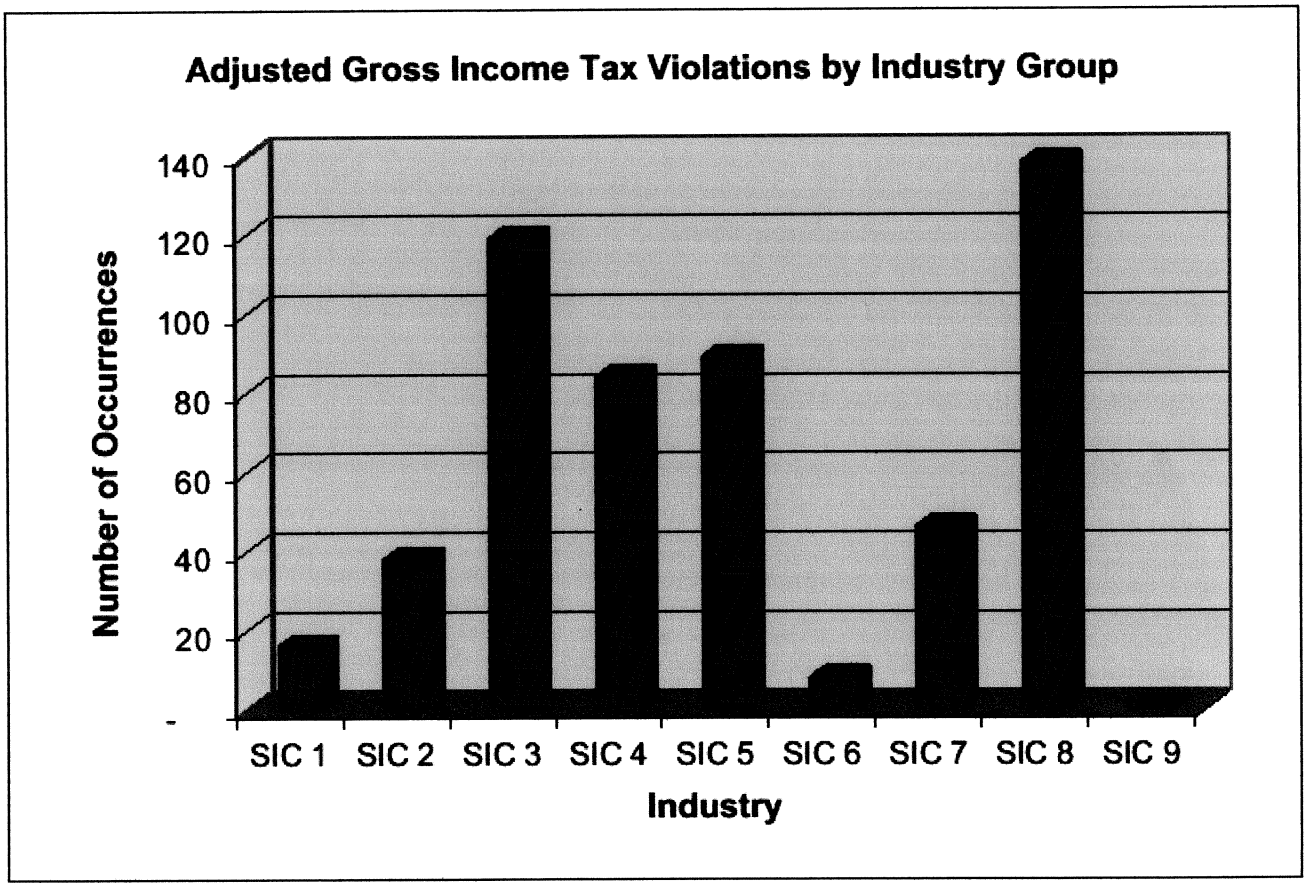
Rationale: Details about the recommendations and supporting rationale are contained in the Center on Budget and Policy Priorities report on Closing Three Common Corporate Income Tax Loopholes Could Raise Additional Revenue for Many States by Michael Mazerov, which can be found at the following URL: http://www.cbpp.org

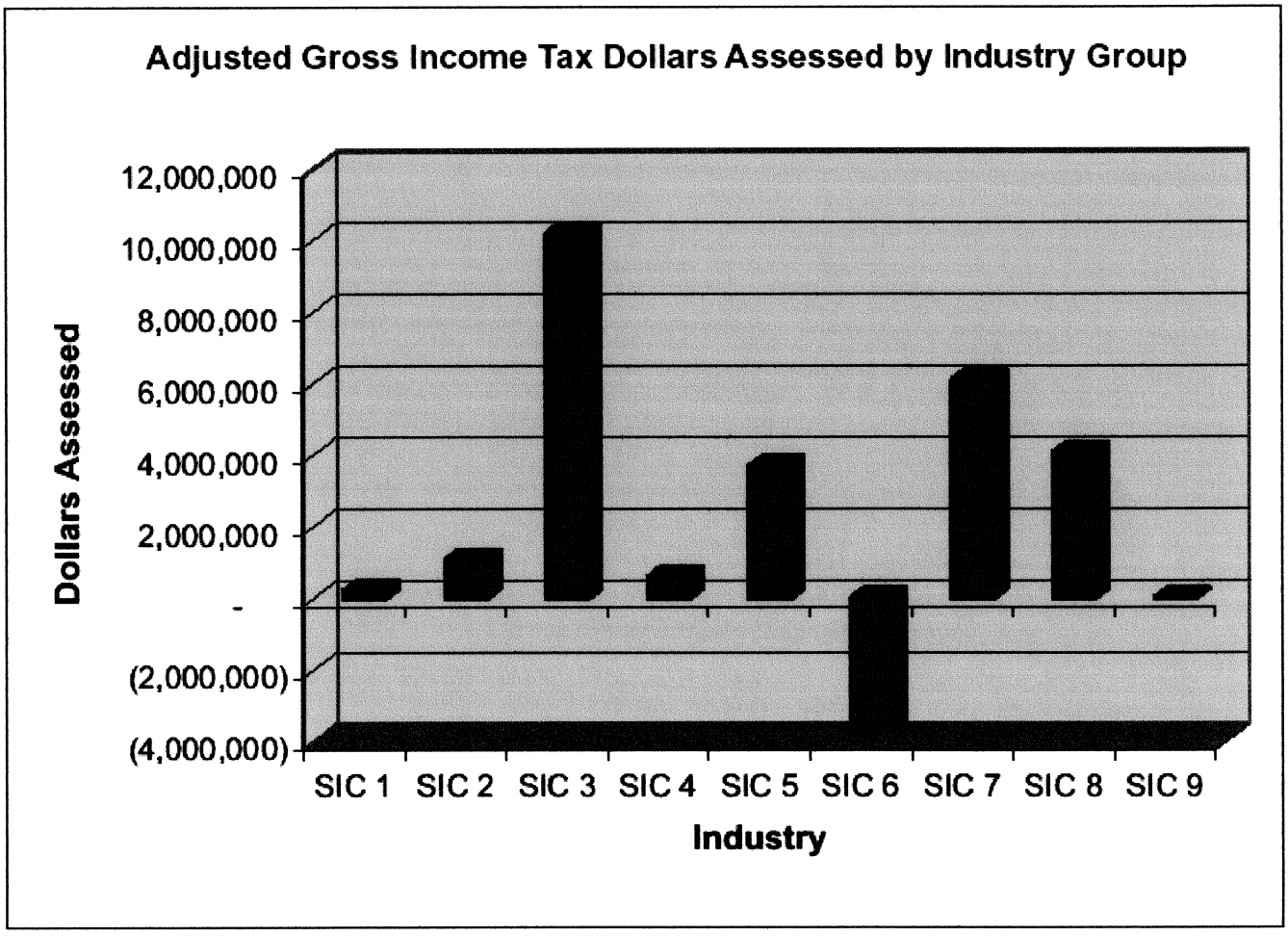
Appendix
Taxpayer statistics

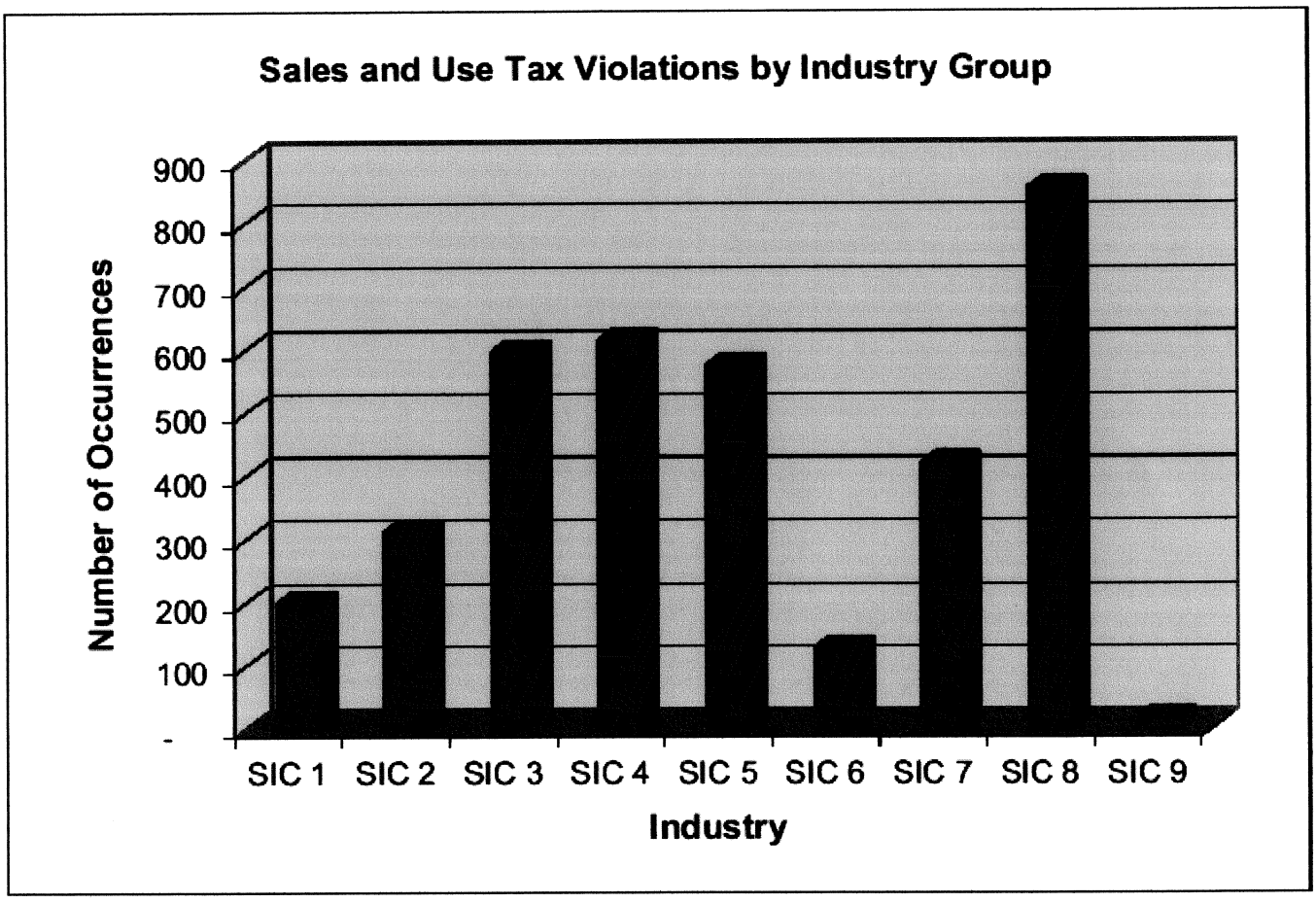
Indiana tax code violations
Source: Indiana Department of Revenue 2003 Annual Report

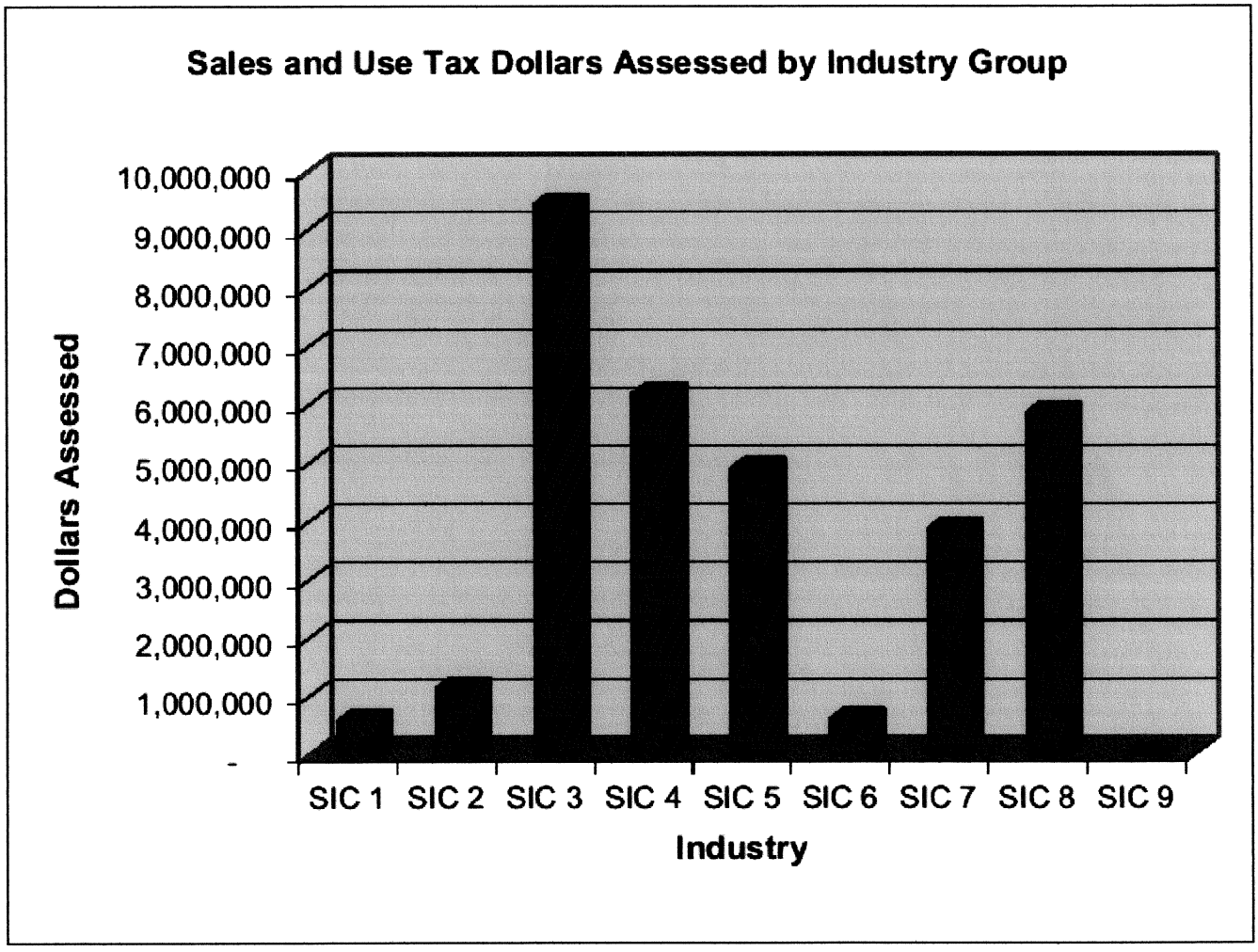



Gross Income Tax Dollars Assessed by Industry Group
Dollars Assessed
12,000,000
10,000,000
8,000,000
6,000,000
4,000,000
2,000,000
-
(2,000,000)
SIC 1
SIC 2
SIC 3
SIC 4
SIC 5
SIC 6
SIC 7
SIC 8
SIC 9
Industry


Adjusted Gross Income Tax Violations by Industry Group
Number of Occurrences
140
120
100
80
60
40
20
-
SIC 1
SIC 2
SIC 3
SIC 4
SIC 5
SIC 6
SIC 7
SIC 8
SIC 9
Industry


Adjusted Gross Income Tax Dollars Assessed by Industry Group
Dollars Assessed
12,000,000
10,000,000
8,000,000
6,000,000
4,000,000
2,000,000
-
(2,000,000)
(4,000,000)
SIC 1
SIC 2
SIC 3
SIC 4
SIC 5
SIC 6
SIC 7
SIC 8
SIC 9
Industry


Sales and Use Tax Violations by Industry Group
Number of Occurrences
900
800
700
600
500
400
300
200
100
-
SIC 1
SIC 2
SIC 3
SIC 4
SIC 5
SIC 6
SIC 7
SIC 8
SIC 9
Industry



STANDARD INDUSTRIAL CODES

The Standard Industrial Codes (SIC) used in the Audit Division reports and exhibits are based on the North American Industry Classification System (NAICS). Refer to the following text to explain the industry classification numbering system.

Class Explanation

1 Agricultural; Forestry
2 Mining; Oil and Gas Extraction; Construction
3 Manufacturing
4 Wholesale; Retail; Transportation
5 Information; Publishing; Telecommunications; Finance; Rental; Insurance; Real Estate; Leasing; Professional Services
6 Education; Health Services
7 Arts; Entertainment; Recreation; Food Service; Accommodations
8 Repair; Personal Services; Other Services
9 Public Administration

Tax Returns by Type

Individual Income Tax Returns	Calendar Year Data (January 1 - December 31)										
	1993	**1994**	**1995**	**1996**	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**
Paper Based					2,574,094	2,530,142	2,255,477	2,208,532	1,679,688	1,428,168	1,361,766
2 D Bar Code							132,757	194,792	528,870	594,716	580,443
Electronic					262,189	341,586	457,597	606,685	736,701	889,428	1,000,431
Internet							6,341	24,948	34,711	43,782	44,941
Telefile							65,447	81,809	71,147	72,177	68,903
Total		**2,726,404**	**2,793,733**	**2,850,957**	**2,836,283**	**2,871,728**	**2,917,619**	**3,116,766**	**3,051,117**	**3,028,271**	**3,056,484**
Percentage of Returns Filed Electronically					**9.2%**	**11.9%**	**22.7%**	**29.1%**	**44.9%**	**52.8%**	**55.4%**

Corporate Income Tax Returns

	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
Total number of returns posted to system	261,295	300,385	326,400	325,274	281,747	225,438	187,375	197,702	204,378	149,229
Add Bar Code Returns						0	0	2	4,096	50,221
Total Corporate Returns						**225,438**	**187,375**	**197,704**	**208,474**	**199,450**

Corporate Income Tax Returns (RPS)

	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
CI-20						2,923	2,233	1,360	1,127	362
FIT-20						534	753	678	649	588
IT-20 Pap 2D								2	1,116	3,787
IT-20						18,418	22,658	23,091	22,024	17,167
IT-20G						378	376	370	383	284
IT-20NP Pap 2D										46
IT-20NP						2,399	2,856	2,866	2,905	2,348
IT 20 S Pap 2D									7	27,908
IT-20S						70,808	77,332	79,945	82,824	56,856
IT-20SC Pap 2D									2,970	5,951
IT-20SC						17,708	20,015	19,164	15,734	11,077
IT-35AR						10,470	19,254	17,655	17,948	20,569
IT-65 Pap 2D									3	12,529
IT-65						30,261	32,915	35,562	38,141	26,837
Total Paper 2D						0	0	2	4,096	50,221
Totals						**153,899**	**178,392**	**180,693**	**185,831**	**186,309**

Withholding Tax Returns

Sales and Use Tax Returns

	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
Total number of returns posted to system	1,196,090	1,180,747	1,155,268	1,184,125	1,147,929	1,127,807	833,618	961,165	963,410	938,941
Sales tax electronic returns (EDI)			EDI numbers not available before '99				875	2,054	3,111	2,117
Total Returns							**834,493**	**963,219**	**966,521**	**941,058**

	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
Total number of returns posted to system	284,050	363,616	398,870	502,585	413,617	439,915	1,165,035	1,462,145	1,439,764	1,384,997
Withholding electronic returns (EDI)					EDI numbers not available before '99		15,105	22,823	28,008	33,710
Total Returns							**1,180,140**	**1,484,968**	**1,467,772**	**1,418,707**
Withholding Tax Returns (Joe Weldon, RPS)										
Withholding Returns (WH-1 Forms)							2,556,944	1,323,196	1,387,140	1,388,625

DATA: Breakdown of Tax Returns by Tax Type

SOURCE: Joe Weldon, Accenture, Linda Dollens, IDOR Returns Processing Center, and Marilyn Cooksie, IDOR IT

Joe Weldon regarding Corporate returns data - "I think the low numbers for 1997 is the result of RPS coming up around then or a little later for COR tax. The discrepancy with 2002 numbers is that we don't have returns for 2002 yet - most corporations file extensions and then the Indiana legislature changed the COR return twice, so we just got out the "new" returns for 2002 to COR taxpayers several months ago."

NOTES:

- Linda Dollens documents to system "These are the documents keyed and sent to the computer system now RPS to be posted to the taxpayer's account".
- Karen B does not think we can compare pre RPS return numbers with post RPS return numbers
- **Joe Weldon:** tax returns do not included amends and they are essentially the same as taxpayers because people only fill out one per year. **Karen Barthelmes**: error rates have reduced with the advent of all the electronic means to file now. The cost has reduced as well. However, I think it is not the forms that promote compliance as much as the new methods to file do. For example, the programs now do not allow many of the errors taxpayers may have made in the past because the form was not clear. They are forced to adhere to the validations in the software.
- **Julie Booth**: corporate returns do not include extensions.
- **Julie Booth**: Corp returns always lag with extensions because, "we follow the federal extension guidelines for filing returns. We think because the forms are so complicated they have to get an extension.
- **Joe Weldon:** Short filers are corp. taxpayers who change their fiscal year, thus it is possible for these taxpayers to have multiple returns